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FINANCING RURAL NONFARM ENTERPRISES: IMPLICATIONS FOR ASIA

by

Richard L. Meyer

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Agricultural Finance Program
Department of Agricultural Economics
and
Rural Sociology
The Ohio State University
2120 Fyffe Road
Columbus, Ohio 43210

ABSTRACT

This paper presents a discussion of several key issues concerning the financing of rural nonfarm enterprises with special emphasis on Asia. The similarities and differences between farm and nonfarm enterprises are discussed. The supply-leading approach to rural finance is reviewed and its shortcomings identified. Financial programs for micro-enterprises are discussed, drawing upon recent evaluations of A.I.D. programs and the Grameen Bank. The paper ends with a discussion of issues to be addressed concerning the expansion of financial services for rural enterprises.

FINANCING RURAL NONFARM ENTERPRISES: IMPLICATIONS FOR ASIA

by

Richard L. Meyer[1]

Introduction

International agencies, central banks, and local governments have channelled billions of dollars into agricultural credit programs and projects in Asia during the past couple of decades. These efforts have been directed in large part to expand agricultural output, accelerate the rate of technological change, and improve rural welfare. Simultaneously, many programs and projects have been implemented to assist cottage industries, handicrafts, and small and medium industries. These latter efforts have frequently had employment creation as their primary objective, but they have also relied heavily on credit as a means to meet their objectives. Currently, there is great interest in very small microenterprises. Once again credit is viewed by many as the primary constraint for these enterprises.

The purpose of this paper is to summarize what we have learned about financing rural enterprises, both farm and nonfarm, and offer some suggestions about directions for the future. The topic is particularly relevant for Asia for two reasons. First, the employment problem is crucial in the region because of the high population density that already exists in several countries, the high population growth rates still found in many

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[1] Professor in the Department of Agricultural Economics and Rural Sociology, The Ohio State University.

countries, and the large numbers of persons expected to enter the work force during the next few years. Second, much can be learned in Asia because the region is rich in experiments and innovations designed to deliver financial services to those farm and nonfarm firms frequently denied access to regular commercial credit sources.

The paper is organized as follows. The next section discusses the similarities and differences between farm and nonfarm enterprises. This is followed first by a short review of supply-leading finance, then a review of microenterprise programs. The paper ends with a discussion of issues that affect the expansion of financial services into rural areas.

Small Farm and Non-farm Enterprises in Rural Areas

Rural enterprises represent a wide variety of types of firms and economic activities. Because of definitional problems, it is hard to analyse the results of different studies and draw definite conclusions about the importance of different types of firms in generating employment. Figure 1 presents a useful framework to view rural households from the perspective of time allocation. Diagrams A - F represent the time allocation of total work time over 1 year of household members in six types of households. The three general categories of economic activities to which time is allocated are a) farming, b) manufacturing, and c) other nonfarm.

Household type A represents the classic type of household considered in a traditional farm management study: all work time of all household members is allocated to farming. Type D is another pure type in which all household time is allocated to manufacturing, either as worker or entrepreneur. Most rural households, especially

Asian, fall between these "pure" forms of households. Type B households mix farm and nonfarm enterprises, such as manufacturing, over the entire year, perhaps because one household member has a permanent off-farm job commuting to a neighboring town. Type C households split their time during the year, perhaps farming during the wet season but migrating to urban areas for manufacturing work during the dry season. The nonfarm allocation of time in C and D could be other nonfarm activities, of course, instead of manufacturing. Types E and F are similar to B and C except manufacturing is combined with other nonfarm activities.

Empirical studies approach these heterogenous enterprises from different perspectives depending on their objectives. Studies of small enterprises often use the perspective of the firm to analyse the nature and geographic distribution of firms. Some cutoff point is selected for size of town or city with which to define a firm as urban or rural regardless of its linkage to the agricultural sector in terms of employment, supply of inputs, or demand for products. These studies essentially assume type D households as entrepreneurs and ignore all economic activities of the household except the enteprise being studied. Some studies take the perspective of off-farm employment of rural households corresponding to type B or C, but this creates a problem when a household member hiring out labor to a neighboring farmer for regular crop cultivation is treated as engaging in nonfarm activities simply because the location of work is outside the individual's household. There are relatively few cases like the Rural Off-Farm Employment Assessment Project (ROFEAP) in Thailand that studied both time allocation of the farm household to farm and nonfarm activities, and the operations of nonfarm firms in villages and small towns.

One of the early attempts to give a quantitative dimension to rural nonfarm employment concluded that 20 to 30 percent of the rural labor force in 15 developing countries was primarily engaged in nonfarm work. When larger towns of 20,000 to 30,000 persons were included in the definition of rural, the percentage rose to roughly 30 to 40 percent (World Bank, 1978).

A recent paper summarizing small scale industry (enterprises with less than fifty workers) surveys conducted in 12 developing countries (including Bangladesh, Indonesia and Thailand) during the late 1970s and early 1980s provides detailed characteristics using the enterprise perspective (Liedholm and Mead). The vast majority of the firms were located in rural areas, and in 10 of the 13 countries analyzed the rural areas accounted for more than half of the total manufacturing employment. Most were one-person firms and 85 percent or more of the firms in all countries employed fewer than six persons. Proprietors and family workers accounted for over half of the total employment. A substantial amount of total hours employed over the year in several countries were devoted to other activities, including farming.

A large amount of evidence is available on income and employment of Asian farm households.[2] Oshima reported the share of nonagricultural income received by farm families in several countries. This share reported as a percent of total income for the most recent year given (ranging from 1975 to 1981) for the countries studied by descending order were Japan 393, Taiwan 186, Thailand 61, Sri Lanka and Malaysia 39, Nepal 36, South Korea 32, Bangladesh 21, Philippines 19, and China 8. These data

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[2] Several country studies appear in Shand.

show the great contribution that such income makes to farm families, but also the diversity among countries.

The ROFEAP data for Thailand showed that on average farm income represented about 35 percent of net household income in villages studied during 1980-81. The proportion was 70 percent in the most intensively cropped province included in the sample, but only 18 to 22 percent in other provinces. Wage income represented a quarter or more of total income for most households. The allocation of time shifted substantially between farm and off-farm work as demands for farm labor changed throughout the cropping season (Onchan and Chalamwong). The nonfarm enterprises of these households included the production of a wide variety of products typically classified as cottage industries. Some households had subcontracts with enteprises in small towns and cities to complete some stages of the production of garments and other products (Akrasanee, et al.).

From the point of view of providing financial services to rural enterprises, it is important to recognize several similarities and differences between small farm and nonfarm enterprises. The similarities are significant. By definition, both are small whether measured in terms of scale of production, capital invested or persons employed. Most employ only family labor. The technology utilized is traditional and may be far behind the most modern enterprises of the same type in the country. Incomes and wages are low, frequently below wage rates in the modern sector; therefore, they are often viewed as subsistence operations. Many sell only a fraction of their total production and are not well integrated into factor and product markets. Likewise, they have limited access to government programs and services, and escape many laws and govern-

ment regulations. In fact, many nonfarm enterprises survive only by avoiding laws and regulations that apply to larger enterprises.

Although they may have deposit and saving accounts, both types of enterprises receive little credit from formal institutions. Loans from friends and relatives furnish much of their start-up capital. They self-finance most of their working capital. Informal lenders provide them with short-term loans frequently at interest rates much higher than regular bank rates. The entrepreneurs participate in a variety of self-help groups, many of which have savings and loan programs. Rotating credit societies (ROSCAs) frequently provide a means of savings, and access to loans for emergencies or selected investments.

Although they aren't well integrated into formal financial institutions, small enterprises employ a rich mosaic of financial transactions. They are frequently small scale lenders and borrowers at the same time, making loans to friends or relatives while taking a loan from a trader. They build up borrowing capacity through voluntary savings, through participation in traditional social groups, and through linking themselves with others who borrow from formal institutions - landlords, traders, input suppliers, richer entrepreneurs. They value and preserve these relationships because with limited cash and capital reserves they need the assurance of being able to borrow in cases of emergency or unusual opportunity. To preserve good relations with informal sources of loans, they repay informal loans before formal ones when they experience cash constraints.

There are, however, important differences between the two types of enterprises. It is well known that the relative importance of agriculture declines with economic growth, while the industrial and service sectors increase. Therefore many small farmers

produce largely homogeneous goods and cannot easily differentiate their products. Nonfarm enterprises often thrive precisely because they successfully develop a product for a market niche. Farm enterprises suffer the risk of natural disasters - weather, disease, pests - while nonfarm enterprises have their share of risks such as interruptions in supplies of water, electricity, and other key production inputs. Nonfarm entrepreneurs also risk the heavy hand of government if they are discovered to be operating without an appropriate license, or are caught disobeying labor laws, or are found to be stealing electricity.

Although small scale enterprises face innumerable obstacles that threaten their survival, policymakers especially note the few formal loans, the lack of long term loans and the high interest rates paid on informal loans, and immediately conclude that credit is their real bottleneck (or at least it is the one problem they think they can do something about in the short term). Furthermore, existing financial institutions, especially banks, are "bad". They are perceived as overly cautious, risk averse and unimaginative with respect to small enterprise lending. Instead, they prefer to lend to their friends in larger enterprises, industry, commerce and trade. Little thought is given to the value that enterprises receive when banks supply safe, dependable deposit and savings services. The "need" of small enterprises is diagnosed as cheap loans.

Supply-Leading Finance[3]

This perception that the primary "need" of rural entrepreneurs is more and cheaper formal loans has led policymakers and donors to develop supply-leading financial programs and policies, first, for small farmers, then for small and medium industries, and now for microenterprise projects. The concept is to supply financial services, mostly loans, in advance of real economic activity so the financial sector will "lead" real growth rather than follow it.

The following summary succinctly characterizes many of the policies and programs designed for small farmer credit, and many of these features can also be found in small and microenterprise programs.

1. Increase the supply of funds available for lending to the priority sector (small farm or nonfarm enterprises) through:
   a. loan portfolio quotas or targets for existing lenders,
   b. the creation of specialized financial institutions to work only with the priority sector(s),
   c. grants and subsidies for non-financial institutions (ministries, departments, institutes, NGOs, PVOs),
   d. central bank rediscount programs, often funded by donors,
   e. mandatory placement of bank and/or public sector deposits in specialized lending institutions, and
   f. nationalization of banks that fail to meet social objectives.

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[3] Parts of this section are taken from Meyer (1989).

2. Reduce the interest rate on loans made to the priority sector through:
   a. interest rate ceilings on loans which set the lowest rates for the smallest/poorest borrowers,
   b. low interest rates charged by the central bank on refinance funds,
   c. encouraging banks to cross-subsidize by charging higher rates to non-priority borrowers in compensation for low rates to priority borrowers, and
   d. direct government interest subsidies to lenders.
3. Reduce lending risks and costs through:
   a. detailed targeting of loans including specifications about production practices and input use required of borrowers,
   b. crop and loan guarantee programs,
   c. creation of joint liability through lending to groups of borrowers, and
   d. technical assistance to lenders to help improve institutional efficiency.

A common characteristic of farm and nonfarm enterprise credit programs is that credit is frequently supplied in conjunction with other services such as training, extension, marketing, and technical assistance. To help insure that technical advice is taken, many farm credit programs provide inputs in kind rather than cash. In other cases, extension agents must inspect and approve farmer loan applications. As will be noted later, there is a substantial debate between the "minimalist" and the comprehensive or integrated package approach to credit.

The supply-leading approach to rural finance has generally been a disappointment. There is a large volume of literature that documents that fact so the results are only highlighted as follows.[4]

1. Lending quotas and targets have been ignored or evaded by lenders through creative loan documentation and multiple small loans to large borrowers.
2. Lenders employ the alternatives offered to increased lending such as investing in low interest government securities.
3. Rural deposit mobilization is discouraged.
4. Interest rate controls result in non-interest rationing of loans that raises borrower transaction costs and concentrates loans among wealthier borrowers.
5. Entrepreneurs divert cheap loans from targeted purposes to higher return uses of funds, and substitute borrowed funds for own capital.
6. Heavy reporting and documentation costs create high lender transaction costs.
7. Political intervention directs subsidized loans to favored clients and protects delinquent borrowers.
8. Lenders experience high loan delinquency and default.
9. The viability of lending institutions is undermined because of their failure to cover costs, recover loans, and mobilize deposits.
10. Lenders are unreliable sources of funds for their customers because they are prisoners to the ebbs and flows of government and donor funds.

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[4] For those desiring to review the literature summarizing studies of rural finance, the following publications may be useful: Adams (1988b); Adams, Graham and Von Pischke; Adams and Vogel; APO 1984 and 1988; Padmanabham; Sacay, Agabin, and Tanchoco; Schmidt and Kropp; and Von Pischke, Adams and Donald.

Although these conclusions are generally relvant for most developing countries, the Asian countries as a group have done comparatively better, expecially in deposit mobilization (Adams, 1988a). Since inflation rates have been somewhat lower in Asian countries, there has been less subsidization of credit through low real interest rates and less rapid deterioration of the real value of loan portfolios than in many developing countries in Africa and Latin America. The principal problem with many projects and programs is that a few select borrowers have received a one-shot increase in liquidity but viable financial institutions have not been built in many countries. A viable rural financial institution is one that is self-sustaining, that covers its costs, that provides services valued by rural households and businesses, that serves an ever increasing number of customers, that is dynamic in providing new financial products and services, and that actively searches for ways to reduce transaction costs for itself and/or its customers. By implication, it operates over a long time horizon and becomes a reliable institution for its clientele.

A major problem with the typical small farmer credit project or targeted credit approach used in many countries is that it doesn't recognize the multiplicity of enterprises found in the rural household. Usually loans are narrowly targeted for specific crop and livestock enterprises. Loans for nontargeted enterprises are often impossible to obtain from formal sources that develop their lending programs based entirely on instructions from the Central Bank or head offices of banks. Due to fungibility, of course, some of these enterprises within a household have benefited from targeted loans because either the loan funds were diverted, or the borrowing households were able to substitute funds

and divert their own savings to nontargeted activities. Special programs for micro-enterprises may offer an alternative source of finance where they exist.

Special Programs for Microenterprises

Problems of urban poverty, declining labor absorption in agriculture, and slow rates of job creation in nonagricultural sectors have stimulated interest in strategies for employment creation and income generation. Programs that foster enterpreneurship and support the economic activities of the poor are seen as effective grassroot efforts to attack poverty and unemployment (Boomgard). This concern has led to a variety of programs, often conducted by NGOs, to stimulate microenterprises.[5] A sharp debate has emerged among the advocates of various approaches. The minimalist approach emphasizes making small loans with little attempt to influence the borrower's use of funds so little support is provided to borrowers besides the loan (Tendler, 1989). The BKK (Bakan Kredit Kecamatan) program in Indonesia is one example as is the Grameen Bank in Bangladesh. This has also been referred to as the market approach because it relies heavily on borrowers using regular financial institutions (Meyer, 1989). The more popular programs, however, are the integrated type in which the support agency provides services in addition to loans, or perhaps even instead of loans. Many NGO and government programs fit into this latter category. Some of these programs will not even provide loans until the borrowers have gone through intensive training and technical

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[5] There is no clear concensus on the definition of micro-enterprise (Levitsky). A frequent operational definition is used in which microenterprises are those with 10 or fewer full-time employees.

assistance programs. Out of 42 programs reviewed, Timberg found only five that could be considered minimalist. A small proportion also emerged in the programs evaluated by Boomgard to be discussed below.

A number of studies have analyzed the performance of microenterprise support programs and projects. A recent survey of the experience of the U.S. Agency for International Development known as Microenterprise Stock-Taking is worth reviewing in detail. A synthesis report (hereafter referred to as the MST report) recently became available which summarizes the results (Boomgard).

The objectives of the Stock-Taking were to determine which approaches to microenterprise development are most consistent with A.I.D.'s goal of broad based economic growth, and to understand the conditions that govern the choices among competing approaches. It focused on projects and programs that have proved effective in generating and sustaining developmental benefits, and in analyzing the factors responsible for their successful performance. Throughout the study, microenterprises were defined as firms that employ 10 or fewer full-time workers. A purposive sample of 32 A.I.D. projects and programs located in 20 countries was selected for detailed study because, to a greater or lesser extent, they targeted assistance to microenterprises, and some analysis of beneficiary impact was available. Most of them either began operations in the 1980s or A.I.D.'s involvement began at that time so they reflect much of the learning that has taken place in this field in the past several years. They are being implemented by PVOs, government agencies and credit unions. Some provide only credit to their beneficiaries, while others also provide training and technical assistance. Included in the sampled programs were the Women's Entrepreneurship Development

Project in Bangladesh, and six Indonesian projects: Financial Institution Development, BKK, KUPEDES, Rattan Export Development, Puskowanjati Women's Cooperative, and the Maha Bhoga Marga Foundation. Eleven programs were included from Africa and 23 from Latin America.

Three distinct approaches identified in the study were used as the conceptual framework for the empirical analysis. The **enterprise formation approach** aims to integrate highly disadvantaged groups or individuals from the survival economy into the microeconomy. They often serve a relatively large proportion of new entrepreneurs and offer a comprehensive range of services focused on creating rudimentary business skills. Much of the direct benefit is in the form of income generation rather than in employment. The **enterprise expansion approach** tries to improve the performance of micro-enterprises. It is essentially marginalist because it emphasizes small, achievable improvements across a relatively large number of firms. Many of these programs have evolved towards the minimalist credit-only orientation to reduce operational costs. The **enterprise transformation approach** actively tries to graduate its clients from micro to small enterprises. These programs often provide an integrated mix of credit, training, and technical assistance to a select group of clients. The firms selected are typically somewhat larger than those assisted through the other approaches so employment generation plays a relatively larger role in the project benefits. In a sense, both the **formation** and **transformation** approaches are transformation-oriented, and this explains their relatively heavy emphasis on technical assistance and training. The **expansion** approach tries to support and enable the existing enterprise, and this accounts for its credit orientation.

Six of the sampled projects and programs were found to emphasize enterprise formation, 22 enterprise expansion, and 14 enterprise transformation. The Bangladesh project was classified enterprise formation, while all but one of the Indonesian projects were considered enterprise expansion.

The principal empirical results of the MST report are summarized in Table 1. Several general features of the programs are presented in the top portion, while information on financial characteristics is presented at the bottom. The enterprise expansion data are presented in columns three, four and five. Column two gives the results calculated for all enterprise expansion programs treated together. Since the group is heterogeneous, the results for the six programs operated primarily as financial institutions are presented in column three, and the results for the remaining programs are summarized in column four. Column six indicates if the differences in the reported means among the groups is statistically significant at the 5% level. Due to some missing data and the wide variance among programs, some of the differences in mean values appear large but are not statistically significant.

Most of these programs, with the exception of the financial institutions, have been operating for only a few years. There are at least three implications of this fact. First, these programs may be superior to some earlier ones because they incorporated improvements learned from past experience. Second, some experienced large start-up costs which may inflate their current cost estimates. Third, credit programs frequently look promising during the first few years of operations when funds are flush, when personnel are enthusiastic, and when they are in the donor spotlight. Later the funds erode due to delinquency and inflation so repeat loans cannot be made to clients, the recovery rate

declines, the portfolio shrinks, and costs per client soar. Therefore, it is unclear if the reported results represent an over- or an underestimation of expected long run costs and sustainability.

Most programs serve only a few hundred clients; the exceptions are the financial institutions that serve thousands. Women represent a significant share of total program beneficiaries in all programs. There is a tendency for the formation and transformation programs to serve a larger percentage of manufacturing firms compared to other types, but the differences are not significant. Average program costs also are higher, but not significant, for formation and transformation programs as is expected with the larger amount of training and technical assistance provided compared to the expansion programs.

There are significant differences in size of loans granted to clients. The average loan size in transformation programs exceeded $3,000 compared to approximately $500-700 in the other programs. This conclusion suggests that attempts to graduate micro-enterprises to small scale firms requires a large enough change in the firm to justify a relatively large loan. It also suggests that transformation programs assume their clients can manage a large loan. The relative loan size can be seen by comparing average loan size relative to GDP per capita. The transformation programs provide loans on average that are ten times the average GDP per capita compared to the other programs which provide loans roughly 1 to 2 times GDP per capita.

Most programs provide 25 to 45 percent of their loans to finance fixed assets, but the financial institutions in the expansion programs distinguish themselves by providing mostly working capital loans. This fact is consistent with their objective of helping clients

make marginal improvements in their businesses. By lending mostly working capital, these institutions also face less stringent staff requirements, so it is easier for them to operate large scale institutions that reach thousands of clients. Fixed asset loans that finance clients to make significant changes in their firms require more skilled manpower to engage in business analysis and loan appraisal, and provide technical assistance to borrowers.

Cost-effectiveness and financial sustainability are issues that all programs face. The range of services provided and the policies employed regarding charging fees and interest rates to clients determine the extent to which programs cover operational costs. Because of the more modest services provided and the large scale of operations, the average program cost per dollar lent is lowest for the expansion programs with an average of just under $0.50. Transformation programs on average cost double that amount, while formation programs cost six times more. These are approximate figures because of the different ways that the programs account for costs not directly associated with credit.

One good indicator of a program's ability to recover costs is the interest rate charged on loans. Differences in these programs on this crucial variable are reflected in their reported average real interest rates (nominal interest rate minus inflation). The expansion programs charge rates that average up to 25 percent, while the other programs have a large subsidy element because they only charge 0 to 3 %. Even the relatively high rates in the expansion programs do not cover the full program costs discussed above however.

The problem of loan delinquency and default complicates the challenge to recover costs. The programs on average reported a percentage of loan funds in arrears ranging from 16 to 24 percent. Assuming that only half of this amount actually results in loan losses implies potential losses of 8 to 12 percent, a level which is difficult for a program to sustain without continuous transfusions of outside funds. Although these programs may strive for financial self-sufficiency, on average they do not charge interest rates high enough to cover operating costs, inflation and reserves for bad debts. The expansion programs come closest to meeting this objective, but generally the other programs are far from it.

The MST report notes that financial self-sustainability is closest to being achieved in the best managed programs which limit their assistance to low cost financial services. These include ADEMI in the Dominican Republic, the BKK and KUPEDES programs in Indonesia, and the CAMCCUL credit union system in the Cameroon. Long term institutional survival and a sustained flow of services is achieved through a combination of earnings, philanthropy, government budget appropriations, and donor assistance. Importantly, credit programs that strive to become self-sustaining, even when the goal is unattainable, generally perform better than programs that expect continuing external support. Organizations that think of themselves as businesses that live or die on the basis of earnings behave differently than those not subjected to this market test.

The MST report concludes that assistance programs that improve the performance of microenterprises without attempting to transform them into more complex businesses have a better record of achievement than do more ambitious transformational programs. These expansion programs typically provide small working capital loans with efficient

screening, rapid disbursement and a reasonable assurance of the availability of larger loans upon repayment. The beneficiaries are poor, but not the poorest of the poor. Benefits are modest for each client, but reach many clients in the form of increased income rather than through large amounts of employment creation. The organizations implementing these programs set out to establish financially self-sustaining credit systems so they adopt a businesslike attitude towards achieving a large volume of lending and operate in a market area large enough to achieve economies of size.

It is noteworthy that many of the characteristics of the most successful programs summarized in the MST report are consistent with the objectives and operations of the Grameen Bank in Bangladesh as reported in the recent comprehensive analysis conducted by Hossain.[6] The target group of the Bank is the rural poor defined as those persons from a household that owns less than 0.5 acres of cultivated land, or assets with a value equivalent to less than 1.0 acres of medium quality land. Persons that meet this criteria are normally not served by the formal financial system, and do not meet the standards set for most crop loans even through special projects targeted for small farmers. Furthermore, about three-fourths of the borrowers in recent years have been women. Loans are not targeted for specific purposes but the members of a borrower's group must agree with the proposed purpose. In 1985, almost half of the loan volume lent to male borrowers was for trading and shopkeeping, while about 45 percent lent to females was for livestock, poultry and fisheries, and another 30 percent for processing and manufacturing. Formal loans for many of these purposes are not available at all, or are

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[6] Additional information on the Grameen Bank can be found in Fuglesang and Chandler, and Meyer and Nagarajan.

only available through the many NGO programs operating in the country. But the NGOs usually limit their operations to a few villages and clients, and provide many services beyond loans.[7]

The Grameen Bank charges a nominal 16 percent interest rate on loans, the same rate other banks charge for agricultural loans. Loans are made for a year and are repaid in weekly installments. In addition, borrowers must contribute to a Group Fund and an Emergency Fund so the effective interest rate is about 25 percent. By the end of 1986, the Bank had almost 300 branches serving 5,000 villages with over 200,000 members. Over 500 million taka (one U.S. dollar approximately equal to 25 taka) were disbursed in 1986. Average loan size is about 3,000 taka or $120. Bank and sample data suggested that the amount of loans unpaid in overdue weekly installments was only about 3 percent. There was a tendency for overdue loans to be higher with borrowers who had borrowed several times from the Bank. The repayment performance is exceptionally good compared to a) other formal lenders in the country, and b) microenterprise lenders elsewhere.

Even with high rates of interest and loan recovery, the Grameen Bank is not completely self-sufficient. Its' administrative costs rose from 14.5 to 18.1 percent from 1985 to 1986, while its cost of funds fell from 5.8 to 3.6 percent. The cost of funds is low because of a large International Fund for Agricultural Development (IFAD) loan at highly subsidized rates compared to the 7-8 percent charged by the Central Bank on its

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[7] Hoque and Ahmed recently completed a review of several microenterprise projects in Bangladesh. Many of their general conclusions were similar to the MST report.

loans to the Bank. This interest subsidy may represent a reasonable way to subsidize the large start-up costs experienced by the Bank as it undergoes a large branch expansion.

The Grameen Bank experience along with the financial institutions studied in the MST report demonstrate how large numbers of microenterprises can be reached with loans. Servicing large numbers of clients with small working capital loans can be done on a self-sustaining or near self-sustaining basis if few services are provided in addition to loans, if high loan recovery levels are achieved and if interest rates are set at high levels. Even in these favorable cases, however, deposit mobilization was not sufficient to provide all the funds lent so the institutions are dependent on external sources.

Expanding Financial Services for Rural Enterprises

It is difficult to clearly determine if formal credit is the most important constraint facing rural enterprises. In surveys, enterpreneurs frequently identify it as an important constraint, but several problems that firms experience, such as excessive inventories, high operating costs, and irregular input supplies, increase working capital requirements and the demand for loans. The growth of financial intermediation is related to the growth of the economy (Fry), so it is desirable to bring households into the realm of formal savings and loan services. Efficient financial intermediaries speed economic development by channelling funds from surplus to deficit units. Through the process of loan allocation, resources flow to the economic units that generate the highest economic returns, some of which will undoubtedly be farm and nonfarm enterprises. Therefore, the issue is what needs to be done to expand the penetration of financial services into rural areas and reduce the urban bias of the financial system.

Access and Transaction Costs

Improved access to formal financial services is directly related to geographic proximity. Banks with a widespread network or a nationwide system of unit banks reduce transaction costs for bank clients.[8] A large share of transaction costs is made up of explicit travel costs and the implicit cost of time in travelling. The closer the bank is to the client, the lower will be the transaction costs. A small PVO program or a government program with only one office for the entire country located in the capital city cannot provide access to many people, particularly for small loans where noninterest costs represent a large share of borrowing cost. A recent APRACA meeting reviewed the experience of several Asian countries attempting to reduce transaction costs through the introduction of banking mobile and mini units. These innovations reduced transaction costs to clients by reducing geographic distance, but it was unclear if they reduced the psychological distance between bank and client. The cost accounting practices used did not permit a comparative analysis of lending costs between a regular branch and these special units (APRACA).

Interest rates have an important impact on access. A policy of charging interest rates high enough to cover program costs is frequently rejected by advocates of lending to the poor. Yet the choice may be between serving fewer clients with low interest loans versus serving many with high interest loans. Programs that do not recover costs from participants and fail to expand their operations deny services to nonparticipants.

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[8] There are few studies that directly measure depositor transaction costs but research such as Khalily et al., clearly demonstrates how the expansion in bank branches in Bangladesh contributed to deposit mobilization.

Furthermore, interest rate ceilings on loans are self-defeating because they raise the cost of credit to the very sector that the government intends to support. The transaction costs and risks of lending to small enterprises is perceived as being greater than lending larger loans to other sectors so lenders either will not make small enterprise loans or will pass on to borrowers a greater share of the risks and costs through noninterest charges (Bhatt; Cuevas and Graham). Low interest ceilings and fixed interest spreads benefit larger borrowers with collateral in Asia at the expense of smaller borrowers with little collateral but with profitable projects (Hiemenz and Bruch).

Low loan rates also imply low rates paid on deposits; this thwarts an institution's ability to mobilize deposits.[9] Without deposits, a lender is dependent on donor and/or government funds. These sources have proven to be quite uncertain; at times, the institution has funds to expand lending while at other times it does not. Inflation erodes the real value of a loan portfolio. If interest rates are too low to compensate for inflation, the real value of new loans made will decline even if the institution achieves 100 percent loan recovery.

There are obvious limits to the level of interest rates that borrowers can pay. Theory suggests that if little capital is used in an enterprise relative to labor, the marginal return on its use must be high. The marginal return from borrowing should also be high, at least for small, incremental loans. Small entrepreneurs usually do not consider the interest rate on formal loans to be an important factor. They put higher priority on speed of loan disbursement, availability of second loans and simplicity of

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[9] A more comprehensive discussion of the importance of deposit mobilization for lending can be found in Meyer, 1986.

procedures (Ashe). The large amount of lending to poor people that occurs in the Indonesian BKK program with rates of 5 to 10 percent per month, and in the Grameen Bank with effective rates exceeding 20 percent per year support this point.

Credit guarantee schemes have been used in several countries to overcome lender resistance to small enterprise lending. These schemes aim to encourage financial institutions to lend to small businesses that have viable projects but that are unable to provide adequate collateral or cannot prove they are creditworthy. These schemes frequently have not lived up to expectations. They are costly, complex to design and manage, and it is unclear if they really contribute to much additionality in lending (Hiemenz and Bruch; Levitsky and Prasad; Magno and Meyer).

Institutional Viability

Institutional viability is closely related to access. If an institution is not self-sustaining, the expansion of its services to new participants will be limited by the amount of subsidies it can extract from governments and donors. By definition, poor countries cannot afford large subsidies; but since the poor are so numerous, large subsidies are required if many clients are to be served. Donors cannot be relied upon to substitute for local resources to keep an institution expanding.

The level of interest rate charged on loans and the spread between lending rate and cost of funds is crucial in determining viability. Interest expense is usually a small component of a borrower's total operating expense, but interest income is usually the most important source of revenue for a lender and may also be important for a nonbank program. Not only must interest rates be raised as noted above, the operating spread must be adequate to cover costs and risks of lending. Government and donor funds

aren't necessarily cheap because of the costs of reporting and documenting their use and impact.[10]

The subsidization of operating costs can have an insidious impact on nonbanking institutions, and especially NGOs functioning in a relatively resource rich environment. When resources are abundant, survival becomes unlinked from performance and self-evaluation is not a priority (Sen). Administration is lax, costs are not controlled, and there is relative indifference to loan recovery. As noted in the MST report, programs that strive for self-sufficiency seem to perform better. This objective gives them an entirely different orientation to lending operations and can increase their chances of long-term survival. Many, but not all, financial institutions have an advantage over specialized lending programs in this regard.

Subsidies also invite political intervention and corruption. Subsidized interest rates create an excess demand for loans so implicit rationing must occur.[11] Political connections can influence who will get a loan. Rent-seeking employees in the financial institutions exploit the opportunity to extract gifts or "tea money" from loan applicants. Leaders of cooperatives and credit unions use their privileged positions to gain disproportionate access to loans. Borrowers with political leverage can avoid loan repayment while borrowers who "bought" their loans see little reason to repay. High loan delinquency is a logical outcome and it can severely weaken an institution. Incentives

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[10] For example, Cuevas and Graham found that lending costs for a private bank in Honduras using donor funds were nearly five times the cost of lending its own money for farmers.

[11] Gonzalez-Vega conceptualized how the Iron Law of Interest Rate Restrictions explains rationing by lenders.

to repay decline even more when borrowers perceive that an institution is weak and they may not get a new loan after repaying the current one.

Multiple Financial Services

Entrepreneurs need financial services, not just loans. A specialized program that only provides loans forces its clients to obtain deposit, savings, and checking services elsewhere. A bank can offer these services in addition to the loan, along with other services such as the international transfer of funds that is important in labor exporting countries. Furthermore, depositors reveal important aspects about their financial management abilities by the way they conduct their deposit and savings operations. This information is useful when lenders process loan applications. Banks recognize the value of this information and often require that an enterprise maintain an account for several months before considering a loan (McLeod). The Grameen Bank requires an established record of weekly savings before members of a group are considered for a loan, and several other programs are now adopting a "savings-first" strategy.

Accepting deposits may also impose discipline on an institution because management realizes that to keep itself credible it must have funds to meet depositor demand. By mobilizing funds and developing its' own programs rather than relying solely on government targeted programs, an institution can escape some political intervention over who gets a loan and who must repay. This may also have a salutary effect on repayment when borrowers recognize they are stealing their neighbor's money rather than the government's when they default on loans. It is frequent in the Philippines, for example, to hear that a "dole-out" mentality affects repayment on government projects (Sacay, et

al.). Cooperatives and credit unions performed well in Latin America in the 1960's, but many deteriorated in the 1970s when they began to accept external funds (Marion).

Graduation

Many special microenterprise programs propose to graduate participants to regular financial institutions once they improve their income and become credit worthy. The rationale for this idea recognizes that as enterprises grow, they pass through different stages of financial sophistication and their financing options widen as they build up their assets and their reputation (McLeod). It is also recommended that programs disburse small amounts as a first loan to a client. This will test repayment ability, but it will also avoid overburdening the business with more money that it can invest wisely (Farbman). Traditional agricultural lenders have been criticized for being inflexible in determining amounts to be lent and have encouraged borrowers to accept more than really needed (Tendler, 1982).

Data on graduation rates are sparse, however, and most program evaluations, if they mention the concept at all, fail to provide much evidence. The fact that data are not readily available suggests that in practice graduation may not really be an important performance indicator. Clearly there are real disincentives for graduation for both program and borrower. If loans granted in special programs are highly subsidized, a borrower will face higher costs when graduating to a commercial source. For the program, graduation implies replacing a good performing participant with a new one with all the costs and learning that implies. Far better and cheaper if funds are tight to extend another loan to the established client.

The graduation problem suggests that a better approach for a specialized micro-enterprise support program may be to not directly lend but instead serve as an advocate to help participants obtain loans from financial institutions. Graduation to larger loans will then occur naturally as repeat loans are made to valued customers. This approach relieves the program of the costs of developing expertise to efficiently manage loan accounts so it can concentrate its resources instead on providing those nonfinancial services it can best provide. Alternatively, it may be possible to graduate or convert the entire program into a financial institution as suggested in the MST report.

CONCLUSIONS

Supply-leading finance for farm and nonfarm enterprises has been an integral part of rural development policy in many Asian countries during the past two decades. The results generally have been disappointing. Although there have been temporary increases in loans for a relatively few lucky borrowers, financial systems have not been created to provide on-going financial services. The amount of funds available to the rural sector, and especially to small enterprises, has actually shrunk in many countries in the past few years after rising during the 1970s.

The emphasis of the supply-leading strategy was misplaced. Policymakers addressed the supposed need of small scale entrepreneurs for cheap loans and ignored how the policies and programs they created undermined the viability of the financial institutions induced or created to make the loans. Evidence of the failure of the strategy can be seen by the multitude of failed and struggling banks, and dependent NGOs and PVOs that survive only through government and donor aid. Unviable institutions cannot

hope to meet the financial needs of small enterprises. They can assist a few participants up to the limits of their subsidies, but they cannot hope to expand their services to a broader number of equally deserving clients. The choice is frequently to serve a few clients with low-interest loans versus reaching many through unsubsidized loans.

Finance is important; a sound financial system is necessary for economic development. The development challenge is to create competitive, viable financial markets in which heterogeneous households of all income levels with appropriate projects will find loans, and will also find suppliers for their checking, deposit and savings needs. Subsidizing a few entrepreneurs with cheap loans contributes little to developing a viable financial market, and it may even retard it.

Strong financial institutions find it difficult to succeed in the unfavorable economic environment that exists in many developing countries. Likewise, entrepreneurs cannot prosper in such an environment, and a few subsidized loans will not resolve their fundamental problems. Increasing employment in rural areas requires the creation of an environment conducive to economic activities, not just tinkering with financial policies.

Figure 1
Commercial Production and Time Allocation in Rural Households

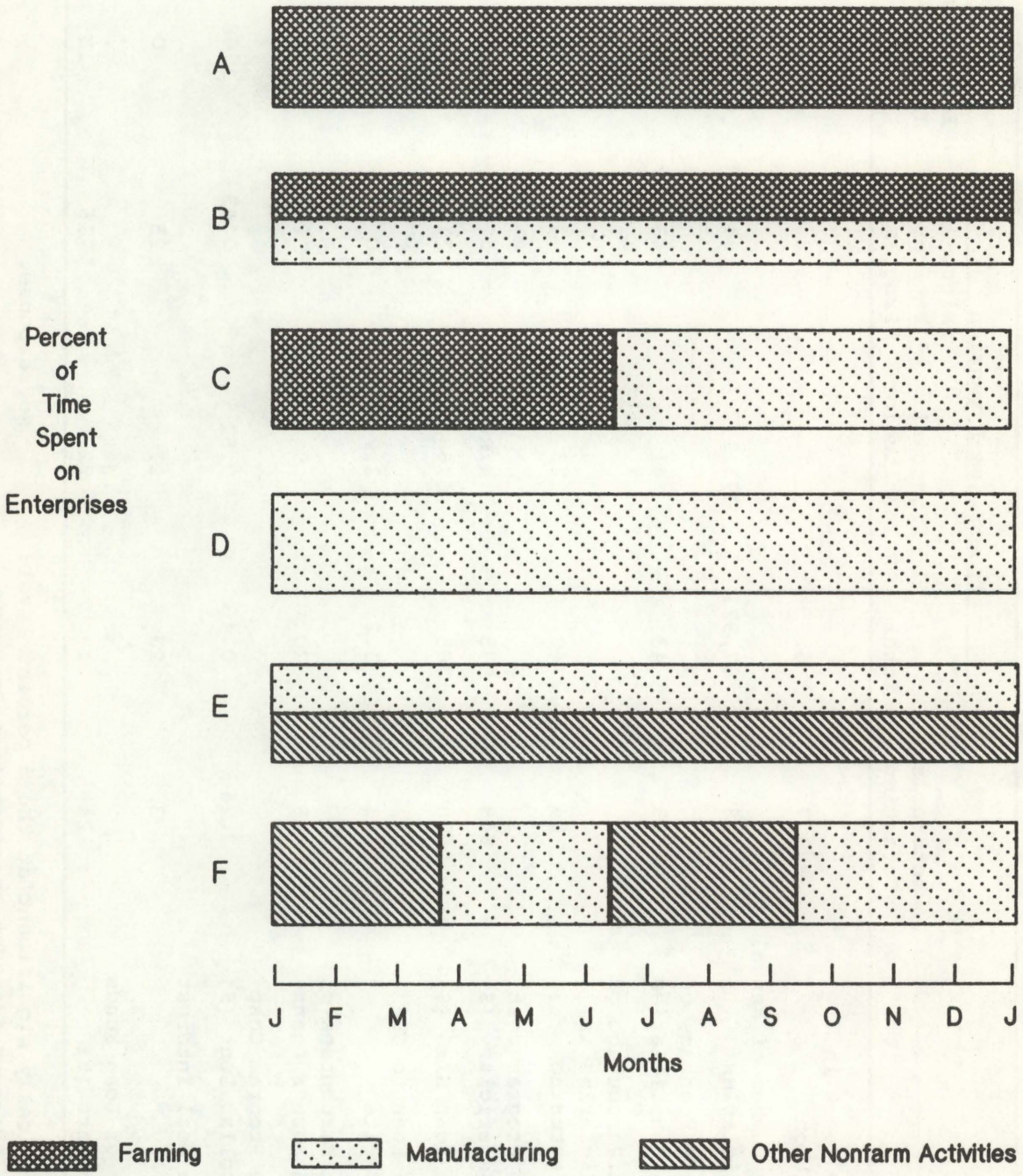

Table 1
KEY RESEARCH FINDINGS

Item	Enterprise Formation	Enterprise Expansion			Enterprise Transformation	Statistically Significant[a]
		Total	Financial Institution	Micro-Enterprise Program		
Average Years in Operation	3.7	4.0	7.3	2.7	2.3	yes
Average Number of Annual Beneficiaries	328	87,871	393,172	642	264	yes
Average Percentage of Women Beneficiaries	59	43	41	43	27	no
Average Percentage of Beneficiaries in Manufacturing	54	40	23	44	60	no
Average Program cost per Beneficiary ($)	948	575	N.R.[b]	575	2,549	no
Average Loan Size ($)	508	705	676	714	3,261	yes
Average Loan to GDP per Capita	1.3	1.2	2.2	0.9	10.2	yes
Average Percentage of Fixed Assets Loans	25	20	9	26	45	no
Average Program Cost per Dollar Lent ($)	3.24	0.46	0.51	0.43	1.08	yes
Average Real Interest Rate	3	23	17	25	0	no
Percent of Loan Funds in Arrears (%)	24	17	22	16	18	no

[a] Statistically significant at the 5 percent level. [b] No response.
Source: Prepared from data presented in Boomgard.

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